Nos. 76-337 and 76-356

In the Supreme Court of the United States

OCTOBER TERM, 1976

CHESTER C. DAVIS, PETITIONER

v.

UNITED STATES OF AMERICA

DAVID B. CHARNAY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 27a-57a) is reported at 537 F. 2d 341. The order of the district court is unreported (Pet. App. 19a-24a).[1]

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[1]"Pet. App." refers to petitioner Davis' appendix (No. 76-337). References beginning with roman numberals denote the count and paragraph numbers of the indictment. "Pet." refers to the Davis petition. "C. Pet." refers to the Charnay petition (No. 76-356).

JURISDICTION

The judgment of the court of appeals was entered on May 7, 1976. A timely petition for rehearing and suggestion for rehearing *en banc* was denied on July 8, 1976 (Pet. App. 58a-61a). On July 28, 1976, Mr. Chief Justice Burger extended petitioner Davis' time for filing his petition (No. 76-337) until September 6, 1976, and the petition was filed September 3, 1976. On August 4, 1976, Mr. Justice Rehnquist denied petitioner Charnay's request for an extension of time to file his petition (No. 76-356). The petition was filed on September 7, 1976, and accordingly is untimely under Rule 22(2) of this Court's Rules. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether execution of a plan to cause the sale of large blocks of a corporation's stock, including short sales, for the sole purpose of depressing the market price of that stock in order to force a sale of the corporation's assets, is an unlawful manipulative device which violates Section 10(b) of the Securities Exchange Act as implemented by Securities and Exchange Commission Rule 10b-5.

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities and Exchange Act, 48 Stat. 891, 15 U.S.C. 78j(b) and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5, are set forth at pages 2a-3a of petitioner Davis' appendix.

STATEMENT

Petitioners and defendants Howard R. Hughes[2] and Robert A. Maheu were indicted in the United States District Court for the District of Nevada. The indictment

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[2]Mr. Hughes died on April 5, 1976. New York Times, April 6, 1976, p. 1, col. 1.

charged that the defendants had knowingly and wilfully conspired to, and did, use manipulative and deceptive devices involving interstate wire communications to depress artificially the price of the common stock of Air West, Inc. ("Air West"), on the American Stock Exchange, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Securities Exchange Act"), 15 U.S.C. 78j (b) and 78ff, and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, and of the conspiracy and wire fraud statutes, 18 U.S.C. 371 and 1343 (Pet. App. 8a-11a; I 11, 12, 13, 14).[3]

The allegations of the indictment were as follows:[4] In August 1968, defendant Hughes, who was the sole stockholder of the Hughes Tool Company ("Hughes Tool") (Pet. App. 6a; I 1), instructed defendant Maheu, the chief executive officer of Hughes/Nevada Operations, a company controlled by defendant Hughes and Hughes Tool (Pet. App. 7a; I 3), and petitioner Davis, an attorney who acted as counsel for Hughes Tool (Pet. App. 6a; I 2), to make an offer on behalf of Hughes Tool to purchase Air West by acquiring its assets for cash at a price designed to yield approximately $22 per share to Air West stockholders (Pet. App. 7a-8a; I 8). On or about December 28, 1968, a bare majority of Air West's stockholders voted to accept the Hughes Tool offer (Pet. App. 8a; I 10). That same day, however, Air West's board of directors rejected the offer by a vote of 13 to 11 (Pet. App. 8a; I 10).

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[3]A prior indictment against these defendants had been dismissed by the district court on January 30, 1974 (Pet. App. 48a). The second indictment, which is the subject of this appeal, was returned within the six-month re-indictment period specified in 18 U.S.C. 3288 (Pet. App. 53a).

[4]The allegations of the indictment are assumed to be true for purposes of determining whether the indictment states an offense against the United States. *United States* v. *A & P Trucking Co.*, 358 U.S. 121, 126, n. 5; *United States* v. *Howard*, 352 U.S. 212, 214-215.

Following the rejection, petitioner Davis, and defendants Hughes and Maheu attempted by various means to induce the Air West directors who had voted against the Hughes Tool offer to change their votes (Pet. App. 9a; I 13). As part of this effort, these defendants represented to the stockholders of Air West, and to others, that if the Hughes Tool offer were rejected, the price of the common stock of Air West would decline substantially (Pet. App. 9a; I 14a).

On December 31, 1968, these defendants, with the assistance of petitioner Charnay and certain other persons, conspired to depress the market price of Air West stock on the American Stock Exchange (Pet. App. 9a-10a; I 14a-c). Petitioner Davis and defendants Hughes and Maheu entered into agreements with petitioner Charnay and with unindicted co-conspirators Herman Greenspun and George Crockett, whereby petitioner Charnay, and Greenspun and Crockett were to sell shares of Air West common stock on the American Stock Exchange (Pet. App. 10a; I 14b). Greenspun and Crockett agreed to sell 27,000 shares which they owned. Petitioner Charnay agreed to sell "short" 59,100 shares (Pet. App. 12a; Overt Acts, para. e, g, i). Petitioner Davis, and defendants Hughes and Maheu agreed to reimburse petitioner Charnay for whatever losses he might sustain in his short sales, and they assured Greenspun and Crockett that they would receive $22 for each share they sold, regardless of the price at which their stock was actually sold (Pet. App. 10a; I 14b).[5]

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[5]Further to induce the non-approving directors to change their votes, petitioner Davis, and defendants Hughes and Maheu, that same day, caused telegrams to be sent to those directors threatening them with the institution of lawsuits if they did not change their votes (Pet. App. 11a; I 14d). The threats were carried out when, that same day, petitioner Davis and defendants Hughes and Maheu caused certain Air West shareholders and directors to file lawsuits

All these sales were effected on December 31, 1968 (except that petitioner Charnay was able to sell short only 19,100 shares) (Pet. App. 12; Overt Acts, para. e, g, i). The sale contributed to and caused a decline that day in the price of Air West common stock on the American Stock Exchange from $18 per share to $15.75 (Pet. App. 10a; I 14c).

Later that same day, as a result of defendants' activities, Air West reversed its earlier position and contracted to sell its assets to Hughes Tool (Pet. App. 12a; Overt Acts, para. j).

The district court dismissed the indictment on the ground that it failed to state an offense (Pet. App. 19a-24a). On appeal by the United States, the court of appeals reversed and remanded for further proceedings. It held (Pet. App. 41a):

> Here the Government has alleged that the appellees in selling their Air West stock purposely sought to depress the market for the stock, and in fact achieved this result, with the object and effect of deceiving the shareholders and directors of Air West in Hughes' takeover attempt. Such conduct falls within the type of activity which Congress sought to prohibit in enacting the Securities [and Exchange] Act and which Rule 10b-5 explicitly prohibits. It constitutes an indictable offense.

In an order denying a petition for rehearing and suggestion for rehearing *en banc*, the court held that the indict-

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against the non-approving directors, charging that their rejection of the Hughes Tool offer constituted a breach of the fiduciary obligation they owed to Air West's shareholders (Pet. App. 11a; I 14d-e). Additionally, petitioner Davis and defendants Hughes and Maheu caused the issuance of court orders directing the seizure of the common stock of Air West owned by the non-approving directors (Pet. App. 11a; I 14e).

ment contained allegations "sufficient to charge the requisite intent and scienter under *Ernst & Ernst* [v. *Hochfelder*, 425 U.S. 185]" (Pet. App. 61a).[6]

ARGUMENT

1. Petitioners contend that the court of appeals erred in holding that the indictment states an offense under Section 10(b) of the Securities and Exchange Act (15 U.S.C. 78j(b)) and Rule 10b-5. In the present posture of the case, however, there is no occasion for the Court to consider that contention.

The district court dismissed the indictment, and the court of appeals reinstated it by reversing the dismissal. The case thus is in the same posture as if the district court had denied petitioners' motion to dismiss the indictment. Such an order would not be appealable (*Heike* v. *United States*, 217 U.S. 423; *Parr* v. *United States*, 351 U.S. 513), because such interlocutory determinations do not terminate the litigation; permitting appeals could thus seriously delay expeditious administration of the criminal law. Cf. *United States* v. *Ryan*, 402 U.S. 530; *Cobbledick* v. *United States*, 309 U.S. 323.

Petitioners have shown no extraordinary circumstances that would warrant this Court now to decide the preliminary question whether the indictment charges an offense. Indeed, the Court may never have to decide that question, since petitioners could be acquitted at their trial, or, if convicted, the court of appeals could reverse their conviction on grounds not warranting review here. If and when petitioners are convicted and their conviction is affirmed, the legal issue petitioners raise will have

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[6]The court of appeals stayed its mandate until disposition of these petitions. None of the defendants is in custody.

been clarified and sharpened by the development of a full record detailing the precise nature and effect of their actions. If the Court deems the legal issue sufficiently important to warrant review, that would be the appropriate occasion therefor. Cf. *Heike* v. *United States, supra,* 217 U.S. at 430; *Parr* v. *United States, supra.*[7]

2. The court of appeals correctly held that the indictment charged a violation of Section 10(b) and Rule 10b-5. That ruling did not rest, as petitioners state, "solely on the basis" of some general purpose of the securities laws (Pet. 5; C. Pet. 6), but because the court found that the indictment "alleged that the * * * [defendants] in selling their Air West stock purposely sought to depress the market for the stock, and in fact achieved this result * * *" (Pet. App. 41a).[8] They were accordingly engaged in a "scheme, or artifice to defraud," and an "act, practice, or course of business which operate[d] * * * as a fraud or deceit" upon all other sellers of Air West stock, as well as on its other stockholders and its directors, within the meaning of the quoted terms as used in

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[7]After a trial, if petitioners are convicted, this Court could review the court of appeals' reversal of the district court's dismissal of the indictment. *E.g., Toledo Scale Co.* v. *Computing Scale Co.,* 261 U.S. 399, 418; *Hamilton-Brown Shoe Co.* v. *Wolf Bros. & Co.,* 240 U.S. 251, 257-258.

[8]The district court similarly characterized the allegations of the indictment as charging the defendants with having "cause[d] substantial blocks of a security to be sold on a national securities exchange for the purpose of artificially depressing the market price of the security * * * " (Pet. App. 23a).

Although petitioners state that "[a]ccording to the Court of Appeals, the conduct at issue is 'certain guarantees against trading losses.' (28a.)" (Pet. 15; see also, C. Pet. 14), the quoted portion of the opinion of the court of appeals refers to that court's characterization of the first indictment, not the indictment involved in the present case (Pet. App. 27a-28a).

Rule 10b-5.[9] Their conduct accordingly violated Section 10(b), which makes it illegal to employ, in connection with the purchase or sale of any security, "any manipulative or deceptive device or contrivance" in contravention of the Commission's rules.

Petitioners contend that activities wilfully undertaken for the purpose of raising or depressing the market price of stock do not constitute a manipulation within the meaning of Section 10(b) and Rule 10b-5 unless (1) the activities are entered into for the purpose of inducing the purchase or sale of securities by others, and (2) the activities give the appearance of trading but do not involve actual transactions. As petitioners recognize (Pet. 18; C. Pet. 16), however, those are the elements which are necessary to show a "manipulation of security prices" in violation of Section 9(a)(2) of the Securities Exchange Act, 48 Stat. 889, 15 U.S.C. 78i(a)(2).

If Congress had intended to limit the prohibition against manipulative schemes and devices to those that Section 9 (a) prohibits, it would not have prohibited in Section 10(b) those devices and contrivances that contravene the Commission's rules. Congress deliberately included in the Act both kinds of statutory prohibition against manipulative activity. It authorized the Commission to make the judgment that investors are as seriously injured when security prices are manipulated for a purpose other than inducing purchases and sales of securities by others, which Section 10(b) bars, as when the manipulation has such a purpose and thus falls under Section 9(a)(2).

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[9]Rule 10b-5 makes it unlawful, in connection with the purchase or sale of a security,

(a) To employ any device, scheme, or artifice to defraud,

* * * * *

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person * * *.

Nor are Section 10(b) and Rule 10b-5 limited to manipulative or deceitful devices based on artificial transactions, such as wash sales or matched orders. Those transactions are expressly proscribed by Section 9(a)(1), 15 U.S.C. 78i(a)(1). Section 10(b) was added to the Act, as a "catchall" clause to enable the Commission to deal with " 'any other cunning devices' " by which markets might be manipulated. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (quoting the testimony of Thomas G. Corcoran, a spokesman for the drafters). Proscribed conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities (*Ernst & Ernst, supra*), may include actual trading. Cf. Section 9(a)(2), 15 U.S.C. 78i(a)(2).

Contrary to petitioners' contention, the decision of the court of appeals does not conflict with the scienter requirement of *Ernst & Ernst* v. *Hochfelder, supra.* That case involved a private claim for damages under Section 10(b) and Rule 10b-5, based on the defendant's allegedly negligent non-feasance. The Court held that a damage action based on these provisions will not lie "in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant." 425 U.S. at 187-188.

In this case, in contrast, the indictment charges that the defendants "*wilfully and knowingly*" employed "manipulative and deceptive devices" (emphasis added) (Pet. App. 8a-9a; I 12), and that the defendants "*did devise and intend to devise* a scheme and artifice to defraud the directors and stockholders of Air West" (emphasis added) (Pet. App. 14a, 15a; III 2, IV 2). The indictment alleges that petitioners caused "substantial blocks of * * * [Air West stock] to be sold on a national securities exchange for the purpose of artificially depressing the market price of" (Pet. App. 23a)

that stock, and that they "in fact achieved this result, with the object and effect of deceiving the shareholders and directors of Air West * * *" (Pet. App. 41a). The charge in this case, unlike that in *Ernst & Ernst,* was wilfull and knowing misconduct, not mere negligent non-action. As the court of appeals explained in denying rehearing (Pet. App. 60a), it—

> did not hold that scienter *per se* was not a required element of the offense. Rather we noted that it *was necessary for the prosecution to show an intentional act* with "a realization on the defendant's part that he was doing a wrongful act." [Emphasis added.]

Such an intent and realization of wrongdoing are plainly alleged.

The decision of the court of appeals does not conflict with *Marsh* v. *Armada Corp.,* 533 F. 2d 978 (C.A. 6). In *Marsh* the court concluded that an alleged manipulative scheme involving elimination of stock dividends did not violate Rule 10b-5 because there had been complete advance disclosure of the defendants' intention to eliminate dividends; there was, therefore, no deceit or fraud on any persons.

In this case the defendants did not disclose their intention to drive down the market price of Air West stock (Pet. App. 44a). The alleged scheme operated as a fraud on anyone who sold Air West stock during the period when its price was artificially depressed as a result of defendants' activities (Pet. App. 10a; I 14c) since they were the victims of petitioners' scheme to drive the price down. Protection against such conduct is the fundamental purpose of the 1934 Act (*Ernst & Ernst, supra,* 425 U.S. at 195) and of Rule 10b-5 (see n. 9, *supra,* p. 8, and discussion, *supra,* p. 9).

Petitioners claim that the indictment denies their Fifth and Sixth Amendment rights, because Rule 10b-5 does not specify what fraud it proscribes, so that petitioners have "no firm idea of what the government claims [they] did that was unlawful" (Pet. 20-21; C. Pet. 18-19).[10] The Commission adopted the rule, however, precisely because it is impossible to define all of the fraudulent and manipulative schemes devious ingenuity can conceive. Rule 10b-5 prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities whether * * * [n]ovel or atypical." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11, n. 7. Petitioners' alleged scheme was fraudulent because it involved a secret device artificially to depress the market price of stock.

Contrary to petitioners' argument, there is nothing novel in the holding of the court of appeals that a market manipulation effected for the purpose of creating an artificial price perpetrates a fraud upon the investing public (Pet. 15-22; C. Pet. 14-19). This holding is reflected in English common law. In *Scott* v. *Brown*, 2 Q.B. 724 (1892), the parties had conspired to purchase shares

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[10]Petitioners' assertion that "[i]t is impossible to find in the indictment who it was that petitioner[s] allegedly intended to deceive or defraud * * * " (Pet. 13; see also, C. Pet. 12-13) ignores the allegations of the indictment that the persons defrauded were, among others, "purchasers and sellers of Air West securities" (Pet. App. 13a; II 2) and "directors and stockholders of Air West" (Pet. App. 14a, 15a; III 2, IV 2), and that as a result of defendants' fraudulent and manipulative activities "Air West" (stockholders who sold their stock in the declining market * * * [received] the proceeds from their sales at artificially depressed prices" (Pet. App. 10a). If petitioners require more definite information they may seek it through a bill of particulars (Pet. App. 47a). Accord, *Tasby* v. *United States*, 504 F. 2d 332 (C.A. 8); *Sullivan* v. *United States*, 411 F. 2d 556 (C.A. 10).

in a company in order to create the appearance of a bona fide market for the shares and that the shares were trading at a premium. The court held the arrangement to be a fraud. See also, *Reg.* v. *Aspinall,* 1 Q.B.D. 730, affirmed, 2 Q.B.D. 48 (1876); *Bedford* v. *Bagshaw,* 4 H. & N. 538, 157 Eng. Rep. 951 (1859); *Rex* v. *DeBerenger,* 3 M. & S. 67, 105 Eng. Rep. 536 (K.B. 1814).

Moreover, prior to the federal securities laws, manipulative activities were held to be unlawful under the federal mail fraud statute. Speaking of a defendant who used a pool to inflate the price of a stock, a district court held: "the substitution of an artificially stimulated and controlled market for an appraisal of the stock in an open and free market" constituted fraud. *United States* v. *Brown,* 5 F. Supp. 81, 84 (S.D. N.Y.), affirmed on other grounds, 79 F. 2d 321 (C.A. 2), certiorari denied *sub nom. McCarthy* v. *United States,* 296 U.S. 650. Similarly, in *Harris* v. *United States,* 48 F. 2d 771 (C.A. 9), a mail fraud case, the court of appeals observed that the violator's "primary purpose * * * was to manipulate * * * stock upon the stock exchanges so that it would have an apparently steadily increasing market value." *Id.* at 775. A distinguished commentator has said of that case that "[t]he cardinal misrepresentation [was] that the price was fixed in a free market, whereas in fact it was fixed by defendant * * *." Berle, *Stock Market Manipulation,* 38 Colum. L. Rev. 393, 397 (1938). Similarly, in the present case, the court of appeals found that the wilfull conduct of defendants in "representing to Air West stockholders and directors that the market would decline if the Hughes tender offer were rejected and their subsequent conduct in driving down the market price without revealing that the

decline was not due to the free operation of market forces * * * operate[d] as a deceit on the market place * * * " (Pet. App. 44a-45a).[11]

CONCLUSION

For the foregoing reasons the petitions for a writ of certiorari should be denied.

Respectfully submitted.

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Solicitor General.

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NOVEMBER 1976.

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[11]Petitioners suggest that this statement by the court of appeals is contrary to *TSC Industries, Inc.* v. *Northway, Inc.*, No. 74-1471, decided June 14, 1976 (Pet. 21-22, n. 7; C. Pet. 19 n.). But *Northway* held only that there is no market manipulation if stock is purchased "wholly independently for proper corporate and investment purposes * * *" (slip op. 24).

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